



McGeorge Law Review

Volume 12 | Issue 3

Article 8

1-1-1980

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Recommended Citation

Ward D. Smith, *Reservation of Rights Notices and Nonwaiver Agreements*, 12 PAC. L. J. 763 (1981).

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Reservation of Rights Notices and Nonwaiver Agreements

The standard liability insurance policy contains a clause providing that the insurer shall have the right and duty to defend suits against the insured.¹ Because the consequences of breaching the duty to defend are severe,² an insurer is reluctant to refuse to defend its insured unless it is clear that the duty to defend has not arisen. The courts and prudence require that, in a doubtful case, the insurer offer to defend the insured.³ If the insurer elects to defend a suit against the insured de-

1. A typical automobile liability policy "defense" clause reads as follows:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of

A. bodily injury or
B. property damage

to which this insurance applies, caused by an occurrence, and the company shall have the right and the duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient, but the company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.

See R. KEETON, BASIC TEXT ON INSURANCE LAW 658 (1971).

2. In *Gray v. Zurich Insurance Co.*, 65 Cal. 2d 263, 280, 419 P.2d 168, 178-79, 54 Cal. Rptr. 104, 114-15 (1966), the California Supreme Court stated that an insurer who wrongfully refuses to defend its insured is manifestly bound to reimburse the insured for the full amount of any obligation reasonably incurred by him. This liability extends to judgments rendered against the insured or good faith settlements entered into by the insured. In *Comunale v. Traders & General Insurance Co.*, 50 Cal. 2d 654, 659, 328 P.2d 198, 201 (1958), the same court indicated that the insurer's liability for wrongfully refusing to defend the insured is limited to the limits of the policy plus attorneys' fees and costs. This rule has generally been followed. See, e.g., *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 536 F.2d 730, 736 (7th Cir. 1976); *State Farm Auto. Ins. Co. v. Allstate Ins. Co.*, 9 Cal. App. 3d 508, 528-29, 88 Cal. Rptr. 246, 258 (1970). Several cases, however, have indicated that the insurer's liability for wrongfully refusing to defend the insured is not inexorably imprisoned within the policy limits. See, e.g., *Miller v. Elite Ins. Co.*, 100 Cal. App. 3d 739, 756, 161 Cal. Rptr. 322, 331 (1980); *Chicken Delight of Cal. v. State Farm Mut. Auto. Ins. Co.*, 35 Cal. App. 3d 841, 849, 111 Cal. Rptr. 79, 84 (1973); *State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co.*, 9 Cal. App. 3d 508, 529, 88 Cal. Rptr. 246, 259 (1970). The issue turns on whether the insured's exposure to damages in excess of the policy limits is proximately caused by the company's refusal to defend. See *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 659-60, 328 P.2d 198, 201 (1958). All of these cases have addressed this issue in dicta only. If a wrongful refusal to defend is coupled with a wrongful refusal to settle, the insurer's liability is not limited to the policy limits. See *id.* at 659, 328 P.2d at 201.

3. See *Blackfield v. Underwriters at Lloyd's, London*, 245 Cal. App. 2d 271, 274, 53 Cal.

spite the fact that it has knowledge of a defense to its duty to indemnify the insured and fails to reserve its right to assert that defense at a later time, the insurer will be equitably estopped to assert that defense in a later action to determine the insurer's liability.⁴ Consequently, insurers frequently offer to defend under a nonwaiver agreement or reservation of rights notice.⁵

Both the nonwaiver agreement and the reservation of rights notice are designed to obtain the insured's consent to allow the insurer to maintain control of the defense and simultaneously preserve the insurer's right to assert a defense to its duty to indemnify the insured. A nonwaiver agreement differs from a reservation of rights notice, however, in one significant respect. A nonwaiver agreement is a bilateral contract, entered into by the insurer and the insured after the injured party has asserted a claim against the insured, that gives the insurer the right to defend the suit against the insured at its own expense while reserving the insurer's right to disclaim liability based on a defense known to it at the time the agreement is executed.⁶ In contrast, a reservation of rights letter is a unilateral notice sent by the insurer to the insured informing the insured of the insurer's intent to maintain control over the defense and of its belief that it has no obligation to indemnify the insured for any settlement or judgment rendered in the action.⁷ The insured's silence generally will be deemed an acceptance of the reservation of rights notice.⁸

The basic problem created by these instruments is that the insurer's interest in restricting its obligation to indemnify the insured seems to conflict with its duty to defend the insured. Because of the conflict of interest inherent in the insurer's position when it seeks to defend a suit for which it denies liability, courts almost universally require that the

Rptr. 838, 840 (1966); *Eichler Homes, Inc. v. Underwriters at Lloyd's, London*, 238 Cal. App. 2d 532, 538, 47 Cal. Rptr. 843, 847 (1965); *Richie v. Anchor Cas. Co.*, 135 Cal. App. 2d 245, 251, 286 P.2d 1000, 1004 (1955).

4. See *Miller v. Elite Ins. Co.*, 100 Cal. App. 3d 739, 755, 161 Cal. Rptr. 322, 331 (1980); *Boise Motor Car Co. v. St. Paul Mercury Indem. Co.*, 62 Idaho 438, 449, 112 P.2d 1011, 1016 (1941); *Beatty v. Employers' Liability Assurance Corp.*, 106 Vt. 25, 33, 168 A. 919, 923 (1933).

5. See, e.g., *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 53 Cal. App. 3d 576, 586, 126 Cal. Rptr. 267, 272 (1975); *Sears v. Illinois Indem. Co.*, 12 Cal. App. 211, 224-25, 9 P.2d 245, 251 (1932); *Employers' Cas. Co. v. Tilley*, 496 S.W.2d 552, 560 (Tex. 1973) (noting that nonwaiver agreements are taken as a matter of course in most cases which insurance companies are called upon to defend).

6. *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 53 Cal. App. 3d 576, 586, 126 Cal. Rptr. 267, 272 (1975); see Note, *Liability Insurance Policy Defenses and the Duty to Defend*, 68 HARV. L. REV. 1436, 1446-47 (1955).

7. See note 6 *supra*.

8. See, e.g., *Roach v. Estate of Ravenstein*, 326 F. Supp. 830, 836 (S.D. Iowa 1971); *Ancateau v. Commercial Cas. Ins. Co.*, 318 Ill. App. 553, 557, 48 N.E.2d 440, 442-43 (1943); *United States Cas. Ins. Co. v. Home Ins. Co.*, 79 N.J. Super. 493, 503, 192 A.2d 169, 174 (1963); *Keystone Club Cas. Co. v. Mauro*, 91 Pittsb. Leg. J. 73, 74-75 (1943).

insured give consent to allow the insurer to control the defense once the insurer has denied liability.⁹ Usually the insured consents to the agreement because the only alternative open to the insured if consent is withheld is to assume control of the defense at his or her own expense and bring a separate action against the insured to determine if the insurer's refusal to defend is wrongful.¹⁰

This comment will examine the nature and incidents of the right and the duty to defend. It will then delineate the two general types of defenses to liability available to an insurer. It will examine the conflict of interest that arises between the insurer and the insured when the insurer asserts a defense to its duty to indemnify the insured but, nevertheless, desires to defend the suit against the insured. It will suggest that as a result of this conflict, the insured is entitled to select independent counsel at the expense of the insurer in any case in which the insurer denies liability for the claim but in which the duty to defend has arisen. It will also seek to define the situations in which the insured may waive the right to independent counsel. Finally, this comment will specifically outline the information that must be conveyed to the insured in a nonwaiver agreement or reservation of rights notice to guarantee that the insured makes an intelligent waiver of the right to an unconditional defense.

WHEN THE DUTY TO DEFEND ARISES

A statement of the traditional rule used to determine when the duty to defend arises appears in *Maxon v. Security Insurance Company*.¹¹ "The general rule is that the obligation to defend is measured by comparing the terms of the insurance policy with the pleadings of the claimants who sue the insured."¹² This rule required the insurer to defend when the allegations of the complaint against the insured included facts that brought the claim within the coverage of the policy.¹³ The carrier had no duty to defend the insured if the injured party's complaint failed to allege facts bringing the case within the coverage of the policy.¹⁴

The rationale underlying the traditional rule was that the insurer should defend any suit in which the allegations, if proved true, would

9. See, e.g., *Hawkeye Cas. Co. v. Stoker*, 154 Neb. 466, 479, 48 N.W.2d 623, 631 (1951); *Connolly v. Standard Cas. Co.*, 76 S.D. 95, 101, 73 N.W.2d 119, 122 (1955).

10. See generally 7C J. APPLEMAN, *INSURANCE LAW AND PRACTICE* §4694 (1979).

11. 214 Cal. App. 2d 603, 29 Cal. Rptr. 586 (1963).

12. *Id.* at 616, 29 Cal. Rptr. at 593.

13. See generally *Moore v. Fidelity & Cas. Co.*, 140 Cal. App. 2d 967, 969, 295 P.2d 154, 156 (1956); *Remmer v. Glen Falls Ins. Co.*, 140 Cal. App. 2d 84, 90, 295 P.2d 19, 22-23 (1956); *Ritchie v. Anchor Cas. Co.*, 135 Cal. App. 2d 245, 250-51, 286 P.2d 1000, 1003-04 (1955).

14. See *Remmer v. Glen Falls Indem. Co.*, 140 Cal. App. 2d 84, 90, 295 P.2d 19, 23 (1956).

entitle the claimant to a judgment against the insured for which the insurer would be liable. Conversely, if the complaint failed to state facts that would give rise to any obligation on the part of the insurer to indemnify the insured, the insurer should not be obligated to defend the suit.¹⁵

Presently, the insurer's duty to defend the insured is not coextensive with its duty to indemnify the insured.¹⁶ In many cases the duty to defend will arise even though there is no duty to indemnify. The California Supreme Court in *Gray v. Zurich Insurance Co.*¹⁷ abandoned the traditional test for determining when the duty to defend arises and broadened the rule to conform to modern rules of pleading and the reasonable expectations of the insured. First, the court held that if the insurer ascertains facts which give rise to the *potential* of liability under the policy, the duty to defend arises.¹⁸ Second, the court held that no longer may the insurer look solely to the allegations of the injured party's complaint in assessing potential liability, but must consider information obtained from any source, including the insured.¹⁹

Clearly the duty to defend under California law is expansive. It is not, however, without limits. In *State Farm Automobile Insurance Co. v. Flynt*,²⁰ the Fourth District Court of Appeal held that an insurer may refuse to defend, even though the complaint alleges facts that bring the claim within the coverage of the policy, if the insurer has information obtained from another source that clearly shows that *no* potential of liability exists under the terms of the policy.²¹ Therefore, under the modern rule, the facts alleged in the injured party's complaint against the insured are of no greater significance than facts obtained from any other source.²² Thus, in California, the insurer's duty to defend extends to any suit in which the complaint alleges the nature and kind of risk covered by the policy, and in which a potential of liability exists.²³

To determine whether a potential of liability exists and, therefore, whether the duty to defend has arisen, the insurer must institute an investigation of the facts surrounding the claim against the insured. California Insurance Code Section 790.03(h)(3) codifies the carrier's

15. See generally *Leonard v. Maryland Cas. Co.*, 158 Kan. 263, 265-66, 146 P.2d 378, 380 (1944).

16. See *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 273, 419 P.2d 168, 173-74, 54 Cal. Rptr. 104, 109-10 (1966).

17. 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).

18. *Id.* at 276-77, 419 P.2d at 176-77, 54 Cal. Rptr. at 112-13.

19. *Id.*

20. 17 Cal. App. 3d 538, 95 Cal. Rptr. 296 (1971).

21. *Id.* at 548, 95 Cal. Rptr. at 302.

22. See *Mullen v. Glen Falls Ins. Co.*, 73 Cal. App. 3d 163, 169-70, 140 Cal. Rptr. 605, 609 (1977).

23. See 65 Cal. 2d at 275, 419 P.2d at 175, 54 Cal. Rptr. at 111.

duty to investigate by defining as an unfair practice the failure to adopt and implement reasonable standards for the prompt investigation of claims.²⁴ The purpose of the insurer's investigation is to alert the insurer to any possible defenses the insured may have to the injured party's claim and any possible defenses the insurer may have to its duty to indemnify the insured in the event the injured party obtains a judgment against the insured.

The insurer should not be deemed to have waived its right to assert a defense to its duty to indemnify by proceeding with a prompt initial investigation.²⁵ Some carriers send a reservation of rights notice to the insured at the outset of an investigation to prevent the insured from mistakenly believing that, by undertaking an investigation of the claim, the insurer is admitting liability for the claim.²⁶ Such a notice is unnecessary, however, if the investigation is instituted promptly.²⁷ Because waiver is defined as the voluntary relinquishment of a *known* right,²⁸ the insurer cannot be deemed to have waived any rights during the initial investigation stage. No waiver can occur until the insurer has had an opportunity to investigate the claim against its insured and thereby apprise itself of available defenses to its duty to indemnify.

THE NATURE OF THE DUTY TO DEFEND

Once the insurer determines that the duty to defend has arisen, it must offer to defend the suit against the insured. Whether the insurer will maintain its contractual right to *control* the defense will depend on whether, in light of the defense known to the insurer, the insurer has sufficient motivation to provide the insured with a vigorous defense.²⁹

24. Insurance Code Section 790.03 provides in pertinent part:

The following are hereby defined as unfair methods of competition and unfair and deceptive acts or practices in the business of insurance.

(h) Knowingly committing or performing with such frequency as to indicate a general business practice any of the following unfair claims settlement practices:

(3) Failing to adopt and implement reasonable standards for the investigation and processing of claims arising under insurance policies.

25. See generally 7C J. APPLEMAN, *INSURANCE LAW AND PRACTICE* §4693 (1979).

26. Telephone interview with William S. Jordan, Claims Supervisor, Metro California Division, State Farm Mutual Automobile Insurance Company (Jan. 21, 1980) (notes on file at the *Pacific Law Journal*) [hereinafter cited as Jordan interview].

27. See generally R. KEETON, *BASIC TEXT ON INSURANCE LAW* §6.6 (1971).

28. *Miller v. Elite Ins. Co.*, 100 Cal. App. 3d 739, 753, 161 Cal. Rptr. 322, 330 (1980); *Loughan v. Harger Haldeman*, 184 Cal. App. 2d 495, 502, 7 Cal. Rptr. 581, 586 (1960).

29. See, e.g., *Babcock & Wilcox Co. v. Parsons Corp.*, 430 F.2d 531, 538 (8th Cir. 1970); *Tomerlin v. Canadian Indem. Co.*, 61 Cal. 2d 638, 648, 394 P.2d 571, 576, 39 Cal. Rptr. 731, 736 (1964); *O'Morrow v. Borad*, 27 Cal. 2d 794, 799, 167 P.2d 483, 486 (1946); *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 810, 94 Cal. Rptr. 347, 354 (1971).

The nature of the proffered defense is dictated by the correlative right³⁰ of the insured to be defended unconditionally.³¹ If the defense tendered by the insurer does not fulfill the insurer's obligation to provide the insured with an unconditional good faith defense, the accompanying contractual right to control the defense may be lost.³² Hence, an examination of the nature of the duty to defend is necessary to determine whether a particular proffered defense fulfills the insurer's duty to defend its insured.

Because the duty to defend is a contractually imposed duty,³³ it must be fulfilled in good faith.³⁴ In California, a covenant of good faith and fair dealing is implied by law in every insurance contract.³⁵ The covenant requires that each contracting party refrain from doing anything to injure the right of the other to receive the benefits of the agreement.³⁶ For the insurer to fulfill its obligation not to impair the right of the insured to receive the benefits of the agreement, it must give at least as much consideration to the latter's interest as it does to its own.³⁷ The precise nature and extent of the duty imposed by the covenant of good faith and fair dealing will depend on the contractual purpose.³⁸

The purpose of the typical insurance defense clause is twofold. First, the insurer desires to minimize its losses by reserving the right to retain competent counsel who will conduct the defense efficiently and thereby increase the likelihood that the insured will prevail in the suit brought by the injured party or, in the alternative, effectuate a reasonable settlement.³⁹ Second, the insured relies upon the insurer to protect his or her legal, economic, and societal interests vigorously so that day to day responsibilities are not interrupted.

Insurance companies, because they profit from inducing the insured to purchase and rely on their coverage rather than securing other pro-

30. See generally Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16 (1913).

31. See *Boise Motor Car Co. v. St. Paul Mercury Indem. Co.*, 62 Idaho 438, 447-48, 112 P.2d 1011, 1016 (1941); *Young Men's Christian Ass'n v. Commercial Standard Ins. Co.*, 552 S.W.2d 497, 502 (Tex. Civ. App. 1977).

32. See, e.g., *Tomerlin v. Canadian Indem. Co.*, 61 Cal. 2d 638, 648, 394 P.2d 573, 577, 39 Cal. Rptr. 731, 737 (1964); *O'Morrow v. Borad*, 27 Cal. 2d 794, 799, 167 P.2d 483, 486 (1946); *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 810, 94 Cal. Rptr. 347, 354 (1971); *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281, 291 (Alas. 1980).

33. See note 1 *supra*.

34. See generally *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958).

35. See note 34 *supra*.

36. 24 Cal. 3d at 818, 598 P.2d at 456, 157 Cal. Rptr. at 486.

37. *Id.* at 818-19, 598 P.2d at 456, 157 Cal. Rptr. at 486.

38. *Id.* at 818, 598 P.2d at 456, 157 Cal. Rptr. at 486.

39. See Note, *The Insurer's Duty to Defend Under a Liability Insurance Policy*, 114 U. PA. L. REV. 734, 748 (1966).

tection against injury, must place the insured's interests above their own.⁴⁰ The typical defense clause gives no indication that the insured will be offered, much less required to accept, a defense under a non-waiver agreement or reservation of rights notice.⁴¹ Under well established principles the words of an insurance contract are construed against the insurer.⁴² Because the typical defense clause states that, in the event the insured is sued, a defense will be forthcoming, the insurer should provide a defense without question in any case alleging the nature and kind of risk covered by the policy. If the insurer believes that it has a defense to its duty to indemnify the insured, it may protect its right to assert that defense by providing the insured with independent counsel.⁴³ The insurance contract, if of any value at all, requires that the insured receive a definite and unequivocal defense.⁴⁴

An insured is not required to accept a defense tendered subject to a nonwaiver agreement or reservation of rights notice.⁴⁵ Under the current state of the law, if the insured rejects the tendered defense, the insurer must either waive its coverage defense and defend unconditionally, or withdraw from the defense of the suit and risk being held liable for wrongful refusal to defend.⁴⁶ The independent counsel offer one possible alternative. If the insurer nevertheless chooses to withdraw, either party may seek declaratory relief to determine if the insurer withdrew wrongfully.⁴⁷

40. See Goodman & Seeton, *Foreword: Ripe for Decision, Internal Workings and Current Concerns of the California Supreme Court*, 62 CALIF. L. REV. 309, 346 (1974).

41. See note 1 *supra*.

42. See *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 269, 419 P.2d 168, 171, 54 Cal. Rptr. 104, 107 (1966); 4 S. WILLISTON, *CONTRACTS* §621, at 764-65 (3d ed. 1968).

43. See *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 810, 94 Cal. Rptr. 347, 354 (1971); *Employers' Ins. Co. v. Beals*, 103 R.I. 623, 634-35, 240 A.2d 397, 403-04 (1968).

44. See *Boise Motor Car Co. v. St. Paul Mercury Indem. Co.*, 62 Idaho 438, 447-48, 112 P.2d 1011, 1016 (1941).

45. See, e.g., 62 Idaho at 449, 112 P.2d at 1016 (1941); *Maryland Cas. Co. v. Peppers*, 64 Ill. 2d 187, 198-99, 355 N.E.2d 24, 31 (1976); *Three Sons, Inc. v. Phoenix Ins. Co.*, 357 Mass. 271, 276, 257 N.E.2d 774, 776-77 (1970); *Hawkeye Cas. Co. v. Stoker*, 154 Neb. 466, 479, 48 N.W.2d 623, 631 (1951); *Sneed v. Concord Ins. Co.*, 98 N.J. Super. 306, 314, 237 A.2d 289, 293-94 (1967); *Motorists Mut. Ins. Co. v. Trainor*, 33 Ohio St. 2d 41, 45-46, 294 N.E.2d 874, 877-78 (1973); *Young Men's Christian Ass'n v. Commercial Standard Ins. Co.*, 552 S.W.2d 497, 502 (Tex. Civ. App. 1977); *American Fidelity Co. v. Kerr*, — Vt. —, —, 416 A.2d 163, 165 (1980). *But see* *Ferguson v. Birmingham Fire Ins. Co.*, 254 Or. 496, 512, 460 P.2d 342, 348 (1969); *Associated Indem. Corp. v. Wachsmith*, 2 Wash. 2d 679, 692-93, 99 P.2d 420, 425-26 (1940).

46. See *Babcock & Wilcox Co. v. Parsons Corp.*, 430 F.2d 531, 537 (8th Cir. 1970); *Charles J. King, Inc. v. United States Fidelity & Guar. Co.*, 264 F. Supp. 703, 708 (S.D.N.Y. 1967); *American Fidelity Co. v. Kerr* — Vt. —, —, 416 A.2d 163, 165 (1980).

47. If the insurer provides the insured with independent counsel when a question as to the insurer's duty to indemnify arises, the rights of both parties can be protected without the necessity of a declaratory judgment action. By eliminating the need for declaratory relief, the insured is freed from the additional expense of a second action and the injured party's relief is not delayed while the insurer and insured determine who will be liable in the event the injured party prevails in the action against the insured. Once the insured's liability to the injured party is established, either the insured or the insurer can seek declaratory relief. If the injured party's action against

THE SIGNIFICANCE OF THE NATURE OF THE DEFENSE
ASSERTED BY THE INSURER

The types of defenses to liability that may be asserted by an insurer fall into two general categories.⁴⁸ The first group contains defenses that, to be maintained effectively, require the insurer to take a position on an issue of fact that conflicts with the position the insured must take on that issue to defend the action brought by the injured party. Thus, these defenses present issues that are subject to proof in the injured party's action against the insured. These defenses typically arise when the insurer alleges that the incident falls outside of the coverage of the policy. The second group of defenses includes those that do not, to be maintained effectively, require the insurer to take a position adverse to that which must be taken to defend the insured in the action brought by the injured party. Thus, these defenses present issues that are not subject to proof in the injured party's action against the insured. These defenses usually relate to an alleged policy breach by the insured.

A. Issues Subject to Proof at Trial

If the defense on which the insurer bases its claim of nonliability is inconsistent with the position that the insurer must take to defend the insured in the action brought by the injured party, the insurer's interests come into conflict with the insured's interests.⁴⁹ While the insurer will want to see the issue resolved so as to absolve it of its duty to indemnify the insured, the insured will want to show that the incident fell within the coverage of the policy.⁵⁰ This problem often arises when the injured party alleges that the conduct of the insured which caused the injury was intentional, but the insured maintains that the conduct was merely negligent.⁵¹ Because liability insurance policies do not cover intentional torts of the insured,⁵² the insurer's interest in the

the insured results in a defense verdict, the need for declaratory relief is eliminated. See generally Note, *Use Of The Declaratory Judgment Action to Determine a Liability Insurer's Duty to Defend—Conflict of Interests*, 41 IND. L.J. 87 (1965); Note, *The Insurer's Duty to Defend Under a Liability Insurance Policy*, 114 U. PA. L. REV. 734 (1966).

48. See generally Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend: A Postscript*, 24 CLEV. ST. L. REV. 18 (1975).

49. See, e.g., *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 809-10, 94 Cal. Rptr. 347, 353-54 (1971); *Maryland Cas. Co. v. Peppers*, 64 Ill. 2d 187, 198-99, 355 N.E.2d 24, 31 (1976); *Prashker v. United States Guar. Co.*, 1 N.Y.2d 584, 593, 154 N.Y.S.2d 910, 917, 136 N.E.2d 871, 875-76 (1956); *Employers' Ins. Co. v. Beals*, 103 R.I. 623, 635, 240 A.2d 397, 403-04 (1968).

50. For example, see 16 Cal. App. 3d at 804 n.1, 94 Cal. Rptr. at 350 n.1 (1971).

51. See generally *Thorton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 335 (1978); *Ferguson v. Birmingham Fire Ins. Co.*, 254 Or. 496, 460 P.2d 342 (1969); Note, *The Insurer's Duty to Defend an Insured in a Personal Injury Action under a Liability Policy That Excludes from Coverage Injuries Caused by the Intentional Conduct of the Insured*, 20 KAN. L. REV. 351 (1972).

52. California Civil Code section 1668 provides:

CERTAIN CONTRACTS UNLAWFUL. All contracts which have for their object, di-

resolution of the issue conflicts with the insured's interest. If the insurer defends the insured, it will desire to have the insured found either free from liability or guilty of an intentional tort. Either result would absolve the insurer of liability. A determination that the insured acted negligently will, by virtue of the doctrine of collateral estoppel, prevent the insurer from denying liability for the claim.⁵³ Hence, the insurer would prefer a finding of nonliability or intentional conduct to a finding that the insurer's insured acted negligently. The insurer's position may give rise to legitimate fears on the part of the insured that the insurer will not properly protect the insured's interests.⁵⁴

The First District Court of Appeal faced a similar situation in *Executive Aviation v. National Insurance Underwriters*.⁵⁵ In *Executive Aviation*⁵⁶ the insured was the operator of an aircraft sales and air taxi business.⁵⁷ An accident, in which several persons were killed, occurred in one of the insured's airplanes while it was being piloted by an employee of the insured.⁵⁸ The conflict between the insurer and the insured arose because the policy only covered charter operations if the pilot in command held a valid license and appropriate ratings for those operations.⁵⁹ The pilot in command at the time of the accident was qualified to conduct sales demonstration flights but was not qualified to conduct charter flights.⁶⁰ Because the insurer was faced with the paradoxical position of having to prove the flight was a charter flight to avoid coverage, while such proof would jeopardize the defense of the action brought by the injured party against the insured,⁶¹ the court held that the insurer must relinquish exclusive control of the defense.⁶² In addition, because the duty to defend had arisen, the court held that the insurer was responsible for the cost of counsel to represent the insured.⁶³ The court noted:

[I]n a conflict of interest situation, the insurer's desire to exclusively control the defense must yield to its obligation to its policy holder.

rectly or indirectly, to exempt anyone for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law.

California Civil Code section 533 provides:

An insurer is not liable for a loss caused by the willful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured's agents or others.

53. See generally Scott, *Collateral Estoppel by Judgment*, 56 HARV. L. REV. 1 (1942).

54. See generally *Babcock & Wilcox Co. v. Parsons Corp.*, 430 F.2d 531 (8th Cir. 1970).

55. 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971).

56. *Id.*

57. *Id.* at 803, 94 Cal. Rptr. at 349.

58. *Id.* at 804, 94 Cal. Rptr. at 350.

59. *Id.* at 803, 94 Cal. Rptr. at 349.

60. *Id.* at 804, 94 Cal. Rptr. at 350.

61. *Id.* at 804 n.1, 94 Cal. Rptr. at 350 n.1.

62. *Id.* at 810, 94 Cal. Rptr. at 354.

63. *Id.*

Accordingly, the insurer's obligation to defend extends to the reasonable value of the legal services and costs performed by independent counsel selected by the insured.⁶⁴

The "independent counsel" solution serves to protect the interests of both the insured and the insurer. The insured receives the vigorous, unconditional defense that it reasonably expected to receive and that the duty of good faith and fair dealing requires the insurer to provide.⁶⁵ The insurer's interests are protected through its ability to participate in the defense in conjunction with independent counsel selected by the insured.⁶⁶ The insurer is able to take a position adverse to that of the insured without compromising the insured's interests.⁶⁷ The added expense of additional counsel seems insufficient reason to deny the insured a defense free from a conflict of interest.⁶⁸

In *Ferguson v. Birmingham Fire Insurance Company*,⁶⁹ the Oregon Supreme Court took a different approach to resolving the conflict of interest dilemma that arises when an insurer denies liability for the claim asserted against the insured but seeks to defend under a reservation of rights notice. The complaint in *Ferguson* alleged a willful trespass by an employee of the insured.⁷⁰ The coverage of the policy did not extend to intentional acts of the insured or one acting at the direction of the insured.⁷¹ The company offered to defend the insured under a reservation of rights agreement.⁷² The insured refused to accept the conditional defense and retained independent counsel.⁷³ The insurer withdrew from the defense.⁷⁴ On appeal of a subsequent action by the insured to recover the cost of defending the suit,⁷⁵ the Oregon Supreme Court held that the insured had been unreasonable in refusing the defense tendered by the company.⁷⁶ While recognizing that the weight of authority would support the insured's demand that the insurer either defend without reservation or withdraw from the defense,⁷⁷ the Oregon

64. *Id.*

65. *Cf. Ivy v. Pacific Auto. Ins. Co.*, 156 Cal. App. 2d 652, 660, 320 P.2d 140, 146 (1958) (holding that the duty of good faith and fair dealing applies to the duty to defend when potential liability is in excess of the policy limits).

66. *See* 16 Cal. App. 3d at 809, 94 Cal. Rptr. at 354.

67. *See id.*

68. *See generally* 16 Cal. App. 3d at 810, 94 Cal. Rptr. at 354; *Employers' Ins. Co. v. Beals*, 103 R.I. 623, 635, 240 A.2d 397, 404 (1968).

69. 254 Or. 496, 460 P.2d 342 (1969).

70. *Id.* at 500, 460 P.2d at 344.

71. *Id.* at 499, 460 P.2d at 344.

72. *Id.* at 500, 460 P.2d at 344 (what the court refers to as a "reservation of rights agreement" is, as those instruments are defined herein, a reservation of rights notice).

73. *Id.* at 496, 500, 460 P.2d at 344.

74. *Id.* at 500-01, 460 P.2d at 344.

75. *Id.* at 501, 460 P.2d at 344.

76. *Id.* at 512, 460 P.2d at 349.

77. *Id.* at 509, 460 P.2d 348.

court held that the rule in Oregon does not require the insurer to make such an election.⁷⁸ The court noted that any conflict of interest between the insurer and the insured could have been eliminated by other means.⁷⁹ First, the court noted that the divergent positions of the insured and the insurer at the liability trial regarding the nature of the insured's conduct⁸⁰ would prevent a determination of that issue from binding the parties in a separate action to determine if the policy provided coverage because collateral estoppel⁸¹ should apply only when the interests of the insurer and the insured on the issue in question are identical.⁸² Therefore, if the injured party's complaint alleges alternative theories of recovery based on negligence and intentional conduct, a finding by the jury that an intentional tort has been committed would not be binding on the insured in a later action to determine coverage.

The approach taken by the Oregon court is open to criticism in that the court failed to consider the difficult position faced by the insured. The insured must cooperate with the insurer in preparing the defense or commit a breach of obligations under the terms of the policy.⁸³ Pursuant to the cooperation clause, the insured could be required to provide the insurer with information that the insurer could later use to establish that the insured's act was not within the coverage of the policy. In effect, the court's holding could create a situation in which the insured would be required to transfer information to the insurer that would not otherwise be available to it.⁸⁴

The *Ferguson*⁸⁵ court recognized as another conflict between the insured and the insurer the possibility that the insurer would only provide a token defense if it is aware that it can later assert a non-coverage defense.⁸⁶ If the insurer does not think that the loss on which it is de-

78. *Id.* at 512, 460 P.2d at 349.

79. *Id.* at 509-11, 460 P.2d at 348-49.

80. *Id.* at 510, 460 P.2d at 348.

81. The court refers to the "estoppel by judgment rule." As the court's discussion refers to the issue of the nature of the insured's conduct, it would appear that the court is referring to the doctrine of collateral estoppel.

82. 254 Or. at 510-11, 460 P.2d at 348-49.

83. The so-called "cooperation clause" is included in virtually every liability insurance policy. A typical cooperation clause reads as follows:

Assistance and Cooperation of Insured. The insured shall cooperate with the company and, upon the company's request, shall attend hearings and trials and shall assist in effecting settlements, securing and giving evidence, obtaining the attendance of witnesses and in the conduct of suits. The insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any other expense other than for such immediate medical and surgical relief to others as shall be imperative at the time of the accident.

See R. KEETON, *BASIC TEXT ON INSURANCE LAW* 655 (1971).

84. See *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281, 291 (Alas. 1980).

85. 254 Or. 496, 511, 460 P.2d 342, 349.

86. See 608 P.2d at 291; Note, *Liability Insurance Policy Defenses and the Duty to Defend*, 68 HARV. L. REV. 1436, 1448 (1955).

fending is covered by the policy, it may not be motivated to achieve the lowest possible settlement or otherwise treat the insured's interest as its own.⁸⁷ The *Ferguson* court believed, however, that the insurer would be adequately motivated by its knowledge that juror sympathy would weigh heavily against it in a subsequent suit by the insured to enforce the policy.⁸⁸ In addition, the court felt that if the insurer's policy defense against the insured was so strong that the insurer would give less than a vigorous defense on the merits of the first action, it would have refused to defend the insured at the time the insured first requested the insurer to defend the action.⁸⁹

Although the *Ferguson* court's assessment of juror sympathy seems to conform to experience,⁹⁰ the belief that an insurer will not hesitate to refuse to defend the insured when it has a defense to its duty to indemnify the insured may be misplaced given the severe consequences of wrongfully refusing to defend.⁹¹ These consequences make insurers extremely reluctant to refuse to defend a suit against the insured.⁹² If an insurer wrongfully refuses to defend, it is certain to be held liable for the settlement or judgment rendered against the insured if later a defense is found to have been warranted.⁹³ In addition, the insurer's liability for wrongfully refusing to defend may not be confined to policy limits.⁹⁴ In contrast, if the insured must accept a defense under a reservation of rights notice, the insurer can insulate itself from liability for wrongful refusal to defend by providing a token defense and thereby restrict its potential liability to the limits of the policy. In addition, the reservation of rights notice will preserve the insurer's right to deny coverage later. The possibility that the insured will receive a token defense is eliminated if, instead of requiring the insured to accept a defense tendered by an insurer who denies liability for the insured's acts, the insured has the right to have independent counsel conduct its defense. If the insurer is faced with the possibility of losing control of the defense each time it issues a reservation of rights notice, it will hesitate to issue such notices based on spurious or weak defenses. Notices will be utilized only in those cases where a legitimate coverage dispute exists.

87. 254 Or. 496, 511, 460 P.2d 342, 349.

88. *Id.*

89. *Id.*

90. See Note, *Use of the Declaratory Judgment to Determine a Liability Insurer's Duty to Defend—Conflict of Interests*, 41 IND. L.J. 87, 95 (1965).

91. See generally *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966); *Tomerlin v. Canadian Indem. Co.*, 61 Cal. 2d 638, 394 P.2d 571, 39 Cal. Rptr. 731 (1964); *Communale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958); Note, *The Insurer's Duty to Defend Made Absolute: Gray v. Zurich*, 14 U.C.L.A. L. REV. 1328 (1967).

92. See note 2 *supra*.

93. See 65 Cal. 2d at 280, 419 P.2d at 179, 54 Cal. Rptr. at 115.

94. See note 2 *supra*.

B. Issues Not Subject to Proof at Trial

The second type of defense likely to be asserted by the insurer does not require the determination of an issue at the trial of the injured party's action that would affect the insurer's policy defense. A typical example of this type of defense occurs when the insurer maintains that it has no obligation under the terms of the policy because the insured has breached the policy in some way. If the position taken by the insurer on the policy defense does not conflict with the position that must be taken to defend the insured, the type of conflict that existed in *Executive Aviation*⁹⁵ does not exist. Nevertheless, a recent Alaska case found that a conflict of interest exists sufficient to entitle the insured to demand control of the defense.

In *Continental Insurance Company v. Bayless and Roberts, Inc.*,⁹⁶ the insurer maintained that the insured had breached the cooperation clause of the policy by lying during a deposition.⁹⁷ Nevertheless, the company offered to defend the insured subject to a reservation of rights notice.⁹⁸ The insured refused to accept the company's offer and assumed control of the defense of the suit.⁹⁹ Some time later, the insured entered into a consent judgment with the injured party.¹⁰⁰ The insured then brought suit against the carrier for breaching its duty to defend the insured.¹⁰¹ In this subsequent suit against the insurer, the Alaska court attempted to resolve the dilemma created when an insurer seeks to defend under a reservation of rights notice but the insured refuses to consent to the proffered conditional defense.

The Alaska court carefully examined the approach taken by the Oregon court in *Ferguson v. Birmingham Fire Insurance Company*,¹⁰² and held that, when the issue in dispute goes to the enforceability of the policy rather than the coverage provided by the policy, the *Ferguson* approach does not adequately protect the rights of the insured.¹⁰³ The court reasoned that even if the insurer vigorously and properly defends the insured, the insurer can nevertheless take actions that might

95. 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971). See generally Scott, *Collateral Estoppel by Judgment*, 56 HARV. L. REV. 1 (1942).

96. 608 P.2d 281 (Alas. 1980).

97. *Id.* at 285-86. An alleged breach of the cooperation clause will rarely be sufficient reason for the insurer to refuse to defend because the breach must cause the insurer substantial prejudice before it will be deemed grounds for relieving the insurer of its obligations under the policy. See generally Hall v. Travelers Ins. Co., 15 Cal. App. 3d 304, 308, 93 Cal. Rptr. 159, 161 (1971).

98. 608 P.2d at 285.

99. *Id.*

100. *Id.* at 283.

101. *Id.*

102. 254 Or. 496, 460 P.2d 342 (1969).

103. 608 P.2d at 290 (Alas. 1980).

prejudice the insured's position in a later suit on the policy.¹⁰⁴ The opinion expressed concern that if the insurer has the right to demand exclusive control of the defense, despite the fact that it claims it has no obligations under the policy, it will be able to gain access to information not otherwise properly available to it, which it could use at a later time to establish the insured's breach.¹⁰⁵ In addition, the court was not persuaded by the *Ferguson* court's belief that when the insurer is defending under a reservation of rights notice or nonwaiver agreement it is adequately motivated to achieve the lowest possible settlement for the insured.¹⁰⁶ In fact, the court suggested that the company failed to settle in the case at bar because it knew it would later have an opportunity to assert the insured's breach as a defense to its obligation to pay a judgment rendered against the insured.¹⁰⁷

The Alaska court held that when the insurer disputes the validity of the policy as opposed to the coverage provided by the policy, the insurer must either relinquish control of the defense or defend unconditionally if the insured is unwilling to consent to a defense under a nonwaiver agreement or reservation of rights notice.¹⁰⁸ The court indicated, however, that the insurer still may be able to preserve its defenses against the insured if it is willing to relinquish control of the defense *and* fulfill its duty to defend the insured.¹⁰⁹ The court suggested that the insurer could preserve its defenses by offering the insured the opportunity to retain independent counsel at the insurer's expense.¹¹⁰ The court's suggestion raises a question as to the applicability of the independent counsel solution to situations that do not require the insurer to take a position adverse to that which the insured must take to defend the action brought by the injured party.

THE INDEPENDENT COUNSEL SOLUTION

A. *The Need for the Independent Counsel Solution*

One distinction seems apparent between the coverage defense asserted in *Ferguson v. Birmingham Fire Insurance Company*¹¹¹ and the policy enforceability defense asserted in *Continental Insurance Company v. Bayless and Roberts, Inc.*¹¹² Because the former type of defense

104. *Id.* at 291.

105. *Id.*

106. *Id.*

107. *Id.* at 291 n.15.

108. *Id.* at 291.

109. *See id.* at 291 n.17.

110. *Id.*

111. 254 Or. 496, 460 P.2d 342 (1969).

112. 608 P.2d 281 (Alas. 1980).

presents a conflict of interest that inevitably will manifest itself at trial, a nonwaiver agreement cannot serve to eliminate the conflict.¹¹³ The insurer's position is inimical to the insured's interests at trial. If the insurer proves what the insured desires to prove, the insurer irreversibly commits itself to indemnifying the insured if the insured is found liable to the injured party. In these cases, the conflict can only be avoided by allowing the insured to select independent counsel at the insurer's expense.¹¹⁴ In contrast, when the defense asserted goes to an alleged breach of the policy, the conflict of interest between the insured and the insurer will probably not manifest itself at trial. The issue that will determine whether a breach has occurred may be so collateral to the main action that the insured is willing to allow the insurer to defend the suit. For example, the policy defense may focus on whether premiums were timely paid. In such a case, the insured may be well advised to enter into a nonwaiver agreement because the issues in the main action are so completely unrelated to the policy defense that the danger of information transfer is very low. If, however, the insured has doubts about the insurer's motivation or interest in providing a good defense or settling the case, and the duty to defend has arisen, the insured should be able to demand that the insurer abandon the defense and defend without reservation or provide the insured with independent counsel to represent the insured's separate interests.¹¹⁵ The insured's decision on this matter may often turn on the strength of the defense asserted by the insurer. If the insurer's defense is weak and the danger of information transfer is low, the insured may believe that the insurer is adequately motivated and able to protect the insured interests.

No California court has yet been called upon to decide if the independent counsel solution should be applied when the insurer's defense does not conflict with the insured's position on an issue that will be resolved during the trial of the injured party's claim. It is suggested, however, that the reasoning of the Alaska Supreme Court in *Continental Insurance Company v. Bayless and Roberts, Inc.*,¹¹⁶ is sound because an inherent conflict of interests exists whenever the insurer disclaims liability for a suit it seeks to defend. The insured may have legitimate fears regarding the insurer's motivation to settle or otherwise provide a vigorous defense.¹¹⁷ In addition, the ever present danger that the insured may be required to produce evidence not otherwise available to

113. *But see* *Employers' Ins. Co. v. Beals*, 103 R.I. 623, 634, 240 A.2d 397, 403 (1968).

114. *See generally* *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); 103 R.I. 623, 240 A.2d 397.

115. *See generally* 608 P.2d 281; *American Fidelity Co. v. Kerr*, — Vt. —, 416 A.2d 163 (1980).

116. 608 P.2d 281 (Alas. 1980).

117. *See* *Babcock & Wilcox Co. v. Parsons Corp.*, 430 F.2d 531 (8th Cir. 1970).

the insurer that could later be used to establish non-coverage justifies the insured's demand that the insurer relinquish exclusive control of the defense.¹¹⁸

B. Objections to the Independent Counsel Solution

One objection that has been made to the independent counsel solution is that the insurer must pay for an additional attorney to defend the insured.¹¹⁹ Given the nature of the duty to defend,¹²⁰ however, this expense is necessary if the insured is to receive the unqualified defense provided for in the policy.¹²¹ Traditionally, if an insurer recognized a conflict of interest between it and its insured, it would inform the insured of the conflict and suggest the retention of an additional attorney at the insured's expense.¹²² Unfortunately, this sometimes placed the insured in the exact position that he or she had purchased insurance to avoid. Because of the high cost of litigation, the insured would sometimes find it economically unfeasible to pay an attorney to oversee the actions of the company that it had expected to protect its interests. It is doubtful that the reasonable expectations¹²³ of the insured upon entering into the insurance agreement included the payment of an attorney. The typical defense clause says nothing about a conditional defense.¹²⁴ In *Gray v. Zurich Insurance Co.*,¹²⁵ the California Supreme Court made it clear that when a term of an insurance contract is ambiguous, the reasonable expectations of the insured must be protected.¹²⁶ Imposing the cost of independent counsel on the insurer seems reasonable in light of the fact that the conflict of interest contingency could be provided for in the contract.¹²⁷

Another objection that has been made to the independent counsel solution is that independent counsel could incur exorbitant defense

118. See text accompanying note 84 *supra*.

119. See Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend: A Postscript*, 24 CLEV. ST. L. REV. 18, 25 (1975).

120. See text accompanying note 30 *supra*.

121. See generally *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); *Boise Motor Car Co. v. St. Paul Mercury Indem. Co.*, 62 Idaho 438, 112 P.2d 1011 (1941); *Employers' Ins. Co. v. Beals*, 103 R.I. 623, 240 A.2d 347 (1968).

122. Jordan interview, *supra* note 26.

123. On the doctrine of reasonable expectations, see generally *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966); Percet, *The Insurance Contract and the Doctrine of Reasonable Expectations*, 6 FORUM 116 (1971); Note, *A Reasonable Approach to the Doctrine of Reasonable Expectations as Applied to Insurance Contracts*, 13 U. MICH. J. OF L. REF. 603 (1980).

124. See note 1 *supra*.

125. 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).

126. *Id.* at 269-70, 419 P.2d at 171-72, 54 Cal. Rptr. at 107-08.

127. See generally *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); *Employers' Ins. Co. v. Beals*, 103 R.I. 623, 240 A.2d 397 (1968).

costs that the insurer would be required to pay.¹²⁸ This objection can be overcome by requiring the insurer to pay only the *reasonable* cost of defending the insured, thus protecting the insurer from inflated defense costs.¹²⁹ The courts are well equipped to determine the reasonable cost of a defense if the insurer believes that independent counsel has incurred needless expenses.

Another objection that has been made to allowing the insured to select independent counsel is that the insured is likely to retain counsel less experienced in trial advocacy than the insurer's counsel.¹³⁰ Although there is always a possibility that the insured will make a poor selection of counsel, this possibility can be minimized if the insurer provides the insured with a list of firms from which to choose.¹³¹ The list should only include firms that do not do a regular business with the carrier to prevent the insured from retaining counsel who may feel obligation or loyalty to the insurer. There is no reason, however, that the list could not include firms that specialize in trial practice or insurance defense work. If the insured selects counsel from the list, the insurer is guaranteed that the selected counsel will have the expertise necessary to provide a defense comparable to that which the insurer would have provided. Finally, because the insurer must only relinquish *exclusive* control of the defense, the insurer is still free to participate in the defense of the suit.¹³² Hence, the insured will still have the benefit of any special expertise possessed by the carrier's counsel, and the insurer's rights will be safeguarded.

Although the preceding objections may present some problems, numerous courts have adopted the independent counsel solution to resolve the conflict of interest dilemma.¹³³ The dilemma that exists when the insurer's position is in conflict with that of the insured in the trial of the injured party's claim has generally been recognized and courts have approved the right of the insured to have separate counsel.¹³⁴ The conflict of interest that exists when the issue in dispute will not be deter-

128. See generally Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend: A Postscript*, 24 CLEV. ST. L. REV. 18 (1975).

129. See text accompanying note 64 *supra*.

130. See generally Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend: A Postscript*, 24 CLEV. ST. L. REV. 18 (1975).

131. But see *id.* at 27.

132. See *Executive Aviation v. National Ins. Underwriters*, 16 Cal. App. 3d 799, 810, 94 Cal. Rptr. 347, 354 (1971).

133. See, e.g., 16 Cal. App. 3d at 809-10, 94 Cal. Rptr. at 354; *Thorton v. Paul*, 74 Ill. 2d 132, 152, 384 N.E.2d 335, 343 (1978); *Satterwhite v. Stolz*, 79 N.M. 320, 324, 442 P.2d 810, 814 (1968) (applying Texas law); *Prashker v. United States Guar. Co.*, 1 N.Y.2d 584, 593, 136 N.E.2d 871, 875-76 (1956); *Socony-Vacuum Oil Co. v. Continental Cas. Co.*, 144 Ohio St. 382, 396, 59 N.E.2d 199, 205 (1945).

134. See, e.g., 16 Cal. App. 3d at 809-10, 94 Cal. Rptr. at 354; 74 Ill. 2d at 153, 384 N.E.2d at 343; 79 N.M. at 324, 442 P.2d at 814 (applying Texas law).

mined at trial, though of a slightly different nature, also entitles the insured to independent counsel.¹³⁵ While it seems clear that in the former case the insured's interests are inimical to the interests of the insurer, and can only be protected by independent counsel, in the latter case the insured may choose to waive the right to independent counsel and allow the insurer to defend under a nonwaiver agreement. If the issue in dispute is totally unrelated to the issues that will be determined at trial and the danger of information transfer is low, the insured may believe that the insurer is adequately motivated to defend or settle the case. In such a case, an effective nonwaiver agreement must be drawn and executed.

The following section will present the essential elements of a non-waiver agreement or reservation of rights notice. These elements help assure that the insured is fully informed of all rights and options and guarantee that any waiver given by the insured is effective.

THE NONWAIVER AGREEMENT OR RESERVATION OF RIGHTS NOTICE

Because some courts have held that unilateral reservation of rights notices are ineffective without the insured's consent,¹³⁶ many insurers prefer to obtain the insured's signature on a nonwaiver agreement.¹³⁷ If the insured refuses to sign a nonwaiver agreement, however, a reservation of rights notice may be sent to the insured. Because the insured's silence upon receipt of a reservation of rights notice will generally be deemed an acceptance of the notice,¹³⁸ the insured should be informed of this fact in the notice to assure that he or she understands the significance of failing to object to the notice. In addition, the insured should be informed of the fact that the notice can be rejected.¹³⁹ Otherwise, a nonwaiver agreement and a reservation of rights notice should contain the same basic information. The elements considered important by the few courts that have examined the nature and purpose of these instruments include: (1) a clear denial of liability for the claim asserted against the insured; (2) the specific grounds and provisions of the policy on which the denial is based; (3) disclosure of the conflict of interest

135. *See generally* *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281 (Alas. 1980); 144 Ohio St. 382, 59 N.E.2d 199.

136. *See, e.g.*, *Hawkeye Cas. Co. v. Stoker*, 154 Neb. 466, 479, 48 N.W.2d 623, 631 (1951); *American Fidelity Co. v. Kerr* —, Vt. —, —, 416 A.2d 163, 165 (1980). *But see* *Ferguson v. Birmingham Fire Ins. Co.*, 254 Or. 496, 509, 460 P.2d 342, 348 (1969); *Associated Indem. Corp. v. Wachsmith*, 2 Wash. 2d 679, 693, 99 P.2d 420, 426 (1940).

137. *See generally* *Welch, Reservation of Rights and Declaratory Judgments*, 381 Ins. L.J. 655 (1954).

138. *See* note 8 *supra*.

139. *See* *Hawkeye Cas. Co. v. Stoker*, 154 Neb. 466, 479, 48 N.W.2d 623, 631 (1951).

that exists between the insurer and the insured; (4) a recommendation that the insured seek the advice of independent counsel prior to signing the agreement; and (5) notification of the insured's options in light of the insurer's denial of liability.

A. Denial of Liability

To avoid any misunderstanding, the instrument should include a clear denial of liability rather than an attempt to reserve the right to deny liability at a later time.¹⁴⁰ In the recent California case of *Miller v. Elite Insurance Co.*,¹⁴¹ the First District Court of Appeal outlined the doctrine of equitable estoppel as applied to an insurer's ability to preserve the right to assert a claim of non-liability against its insured.¹⁴² An estoppel will arise if the insurer defends without denying liability.¹⁴³ If the insurer denies liability and fails to withdraw from the defense or execute a nonwaiver agreement with the insured, estoppel will prevent the insurer from denying liability at a later time.¹⁴⁴ Hence, to prevent an estoppel from arising, the insurer must make clear to the insured that it denies liability for any settlement or judgment rendered against the insured despite the fact that it is willing to undertake the insured's defense.¹⁴⁵ Only then will the basic nature of the conflict of interest be unmistakably clear to the insured.

B. Specific Grounds on Which the Denial of Liability is Based

A general denial or bare reservation of rights does not adequately inform the insured of the insurer's position.¹⁴⁶ Thus, courts require that the insurer include in the agreement the specific grounds or policy provisions on which the denial is based.¹⁴⁷ The rationale underlying

140. See *Popovich v. Gonzales*, 4 Ill. App. 3d 227, 230, 280 N.E.2d 757, 760 (1973); *Henry v. Johnson*, 191 Kan. 369, 377, 381 P.2d 538, 545 (1963). See generally CAL. INS. CODE §790.03, which provides in pertinent part:

The following are hereby defined as unfair and deceptive acts or practices in the business of insurance. . . .

(h) Knowingly committing or performing with such frequency as to indicate a general business practice any of the following unfair claims settlement practices. . . .

(4) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss requirements have been completed and submitted by the insured.

Although the language of this Section is couched in terms of claims made by the insured for personal loss, the courts have not yet been called upon to interpret subsection (4) and may be inclined to extend its application to claims asserted against the insured as well as claims asserted by the insured.

141. 100 Cal. App. 3d 739, 161 Cal. Rptr. 322 (1980).

142. *Id.* at 754-55, 161 Cal. Rptr. at 330-31.

143. See *id.* at 755, Cal. Rptr. at 330-31.

144. See *id.*

145. *Id.*

146. See *Cowan v. Ins. Co. of North Am.*, 22 Ill. App. 3d 883, 896, 318 N.E.2d 315, 326 (1974).

147. See, e.g., *id.* at 896, 318 N.E.2d at 326; *Meirthew v. Last*, 376 Mich. 33, 39, 135 N.W.2d 353, 355 (1965); *Weber v. Biddle*, 4 Wash. App. 519, 524-25, 483 P.2d 155, 159 (1971).

this specificity requirement is that a general denial of liability or coverage does not convey sufficient information to enable the insured to determine whether or not there is a need to be represented by independent counsel.¹⁴⁸ Only when the insured is adequately informed of the potential defense can there be an intelligent choice between seeking independent counsel or accepting the defense tendered by the insurer.

In addition, a general denial, by its inherent vagueness, is subject to abuse in that it can be asserted as a precautionary measure even though no specific defense has come to the attention of the insurer.¹⁴⁹ The sanctioned use of general denial provisions in nonwaiver agreements or reservation of rights notices removes the insurer's motivation to pursue a prompt and thorough investigation. Through use of a general denial, the insurer can preserve all possible defenses whether known to it or not. The insured's interests are better protected if the insurer institutes a prompt investigation at the time the insured first requests the company to defend the suit. If the insurer intends to deny coverage, the insured should be apprised of this intention at the outset of the suit and should not be forced to decide whether to demand control of the defense after the insurer has undertaken it.

C. The Conflict of Interest

Any time an insurer defends subject to a nonwaiver agreement or reservation of rights notice, a conflict of interest exists between the insured and the insurer because the insurer seeks to control the defense of a suit for which it disclaims any obligation to pay a judgment rendered.¹⁵⁰ This conflict of interest imposes certain responsibilities on the attorneys involved in the suit.¹⁵¹ As counsel for the insured, an attorney retained by the carrier owes the same duty to the insured as would have been owed had the insured retained it in the first instance.¹⁵² Therefore, when a defense becomes known to the insurer that calls for a nonwaiver agreement to be drafted and presented to the insured, the attorney representing the insured at the direction of the insurer must be careful to make his or her position and loyalties clear to the insured. If the attorney is requested by the insurer to draft and obtain the insured's

148. See 22 Ill. App. 3d 883, 896, 318 N.E.2d 315, 326.

149. See generally 376 Mich. 33, 135 N.W.2d 353.

150. See *Fulton v. Woodford*, 26 Ariz. App. 17, 20, 545 P.2d 979, 982 (1976).

151. See generally Corboy, *Defending Insurance Companies and the Insured-Can Two Masters Be Served?*, 55 CHI. B. REC. 102 (1973); Germer & Tebbs, *Conduct of Defense Attorney and Insurance Company in Defending an Insured Where a Coverage Question Is Involved*, 13 S. Tex. L.J. 223 (1972); Note, 52 TEX. L. REV. 610 (1974).

152. *Lysick v. Walcom*, 258 Cal. App. 2d 136, 146, 65 Cal. Rptr. 406, 413 (1968).

signature of a nonwaiver agreement, the attorney must disclose the conflict of interest to the insured to avoid the danger that the insured will believe that the agreement is a mere formality or that the attorney is recommending that the insured sign the agreement. It is essential that the insured recognize that in this situation, the attorney is the emissary of the insurer.

Although some insured parties have the knowledge and sophistication to recognize the conflict of interest that the insurer's denial of liability presents, many will be unaware of the problem unless it is revealed by the insurer. All of the ramifications of the insurer's denial of liability cannot be explained within the nonwaiver agreement, but the basic conflict of interest can be described. The insured must understand that the possibility exists that an issue will come into dispute with the insurer that will require the insurer to relinquish control of the defense to an attorney to be selected by the insured at that time. Only if the insured understands this aspect of the conflict can the insured make an intelligent decision whether to select independent counsel at the outset or allow the insurer to defend.

The American Bar Association Code of Professional Responsibility has specifically recognized that the relationship of an attorney retained by an insurer to represent its insured often creates ethical problems for the attorney.¹⁵³ Canon 5 deals specifically with the conduct required of a lawyer who represents clients with conflicting or potentially conflicting interests.¹⁵⁴ Ethical Consideration 5-16 provides:

In those instances in which a lawyer is justified in representing two or more clients having differing interests, it is essential that each client be given the opportunity to evaluate his need for representation free from any potential conflict and to obtain other counsel if he so desires. Thus before a lawyer may represent multiple clients, he should fully explain to each client the implications of the common representation and should accept or continue employment only if the clients accept.

Hence, the attorney should divulge the potential conflict of interest immediately upon becoming aware of a potential defense available to the insurer.

D. The Advice of Independent Counsel

In light of the conflict that a nonwaiver agreement creates for the attorney retained by the insurer to represent the insured, the insured always should have the advice of independent counsel before signing a

153. See ABA CODE OF PROFESSIONAL RESPONSIBILITY, Ethical Consideration 5-17 (1979).

154. See generally *id.*

nonwaiver agreement.¹⁵⁵ In some cases, however, the insured will agree to sign a nonwaiver agreement without consulting independent counsel.¹⁵⁶ To protect the attorney and the insurer from a claim that their conduct was unethical, a recital should be included within the agreement stating that the insured has been advised of the wisdom of seeking independent legal advice and has done so or has declined to do so.

E. The Options Available to the Insured

As insured parties often will be unaware of their right to demand that the insurer either abandon its defense and defend unconditionally or withdraw from the defense, the insurer should inform the insured of that option.¹⁵⁷ If the insurer does not inform the insured that the insured is entitled to a defense free from any conflict of interest, the insurer has deprived the insured of the benefits of the insurance contract and in so doing has breached the covenant of good faith and fair dealing.¹⁵⁸ Arguably, the insurer's duty of disclosure would extend to informing the insured that if he or she chooses not to allow the insurer to control the defense, independent counsel will be provided and paid for by the insurer.¹⁵⁹

The insured must understand that the agreement does more than preserve the insurer's right to assert a defense. A nonwaiver agreement is so named because, in theory, it prevents a waiver of the insurer's rights to assert a defense to its obligation to indemnify the insured.¹⁶⁰ In actuality, the instrument has a dual purpose. First, it informs the insured of any defense on which the insurer intends to rely and thereby prevents the insured from mistakenly believing that the insurer admits liability for a judgment rendered on the injured party's claim. Second, it obtains the insured's consent to allow the insurer to defend the suit despite the fact that the insurer denies liability for the claim against the insured. Thus, in effect, a nonwaiver agreement constitutes a *waiver* of the insured's right to be defended unconditionally.¹⁶¹ Similarly, a res-

155. See *id.* at Ethical Consideration 5-16. It has been suggested that counsel retained by the insurer is incompetent to disclose adequately the conflict of interest that exists between the insured and the insurer. See Note, *The Insurer's Duty to Defend Under a Liability Insurance Policy*, 114 U. PA. L. REV. 734, 746 (1966).

156. Jordan interview, note 8 *supra*.

157. See generally *Hawkeye Cas. Co. v. Stoker*, 154 Neb. 466, 48 N.W.2d 623 (1951).

158. See generally *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979); *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958).

159. See generally *Browne, The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend*, 23 CLEV. ST. L. REV. 423 (1974).

160. See generally 7 C.J. APPLEMAN, INSURANCE LAW AND PRACTICE §4694 (1979).

161. See *Young Men's Christian Ass'n v. Commercial Standard Ins. Co.*, 552 S.W.2d 497, 502 (Tex. Civ. App. 1977).

ervation of rights notice fairly states the effect of the instrument on the rights of the insurer but fails to indicate that the insured is relinquishing the right to assume control of the defense. When the instrument is a unilateral reservation of rights notice the insured's silence upon receipt of the instrument generally will be deemed acquiescence.¹⁶² Unless the insured fully understands the effect and significance of the instrument, there can be no effective waiver of the right to be defended unconditionally.¹⁶³

CONCLUSION

The conflicting interests of an insurance carrier and its insured when the former seeks to defend the latter under a reservation of rights notice or nonwaiver agreement require that courts make a special effort to protect the rights of the insured. If the company disclaims liability for a claim against the insured, it must either abandon its defense and defend unconditionally, withdraw from the defense and risk liability for wrongfully refusing to defend or provide the insured with independent counsel. If the position taken by the insurer is adverse to the position the insured must take to defend against the injured party's claim, the insurer must relinquish exclusive control of the defense. This conflict of interest cannot be eliminated by a nonwaiver agreement because the insurer's interests are inimical to those of the insured. The insurer's duty to defend in such a situation extends to paying the reasonable value of independent counsel. Likewise, if the insurer's position is not in direct conflict with the insured's position in the trial of the injured party's claim against the insured, because the insurer disclaims liability for the injured party's claim, the insurer's interests are nevertheless in conflict with those of the insurer. Hence, the insured should be given the option to select independent counsel at the insurer's expense.

In order to assure that the insured gives a knowing, intelligent waiver in those cases where a nonwaiver agreement is appropriate, a nonwaiver agreement must convey sufficient information to the insured to fully inform the insured of the insurer's position and the options available to the insured if the nonwaiver agreement is unacceptable. If the insurer offers to provide the insured with independent counsel in those instances in which the insurer seeks to defend the insured under a reservation of rights notice or nonwaiver agreement, the insured will understand the rights and options under such instruments. Only if the insured understands the available options will the insured's consent to

162. See note 8 *supra*.

163. See text accompanying note 28 *supra*.

allow the insurer to defend the suit constitute an intelligent waiver of the insured's right to an unconditional defense. Consequently, the right of the insured to be defended free from a conflict of interest will be safeguarded.

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